The Frontier Line

A comprehensive analysis of the costs and benefits of multi-strategy hedge funds

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for over 25 years and provides advice on over $600 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing, customisation, technology solutions and an alignment and focus unconstrained by product or manager conflict.

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Alex Perisanidis joined Frontier Advisors in 2022 as an Associate in the Alternatives Team. Alex is responsible for providing advice to clients on alternative investments as well as derivative securities. Prior to joining Frontier, Alex worked at Deloitte where he advised financial institutions, primarily banks and insurers, on modelling and analytics related to market and credit risk.

Alex holds a Bachelor of Science in Mathematics and Statistics, specialising in Statistics and Stochastic Processes, from The University of Melbourne. Additionally, he has passed Level 2 of the CFA program.

Introduction

This paper introduces and explores multi-strategy hedge funds and why we believe it can be an optimal one-stop hedge fund solution for allocators. Multi-strategy funds employ a number of investment strategies within the single fund. By blending a diverse set of strategies, these funds are able to capitalise on market opportunities across various market conditions.

With respect to allocation, multi-strategy funds may be a great option for smaller allocators looking to minimise the number of individual allocations made, or as a starting point for building an alternative assets portfolio.

In this paper, we delve into the intricacies of multi-strategy funds, highlighting the benefits of inclusion into an otherwise diversified institutional portfolio. Additionally, we examine some critical questions about fees and the importance of manager selection.

Background

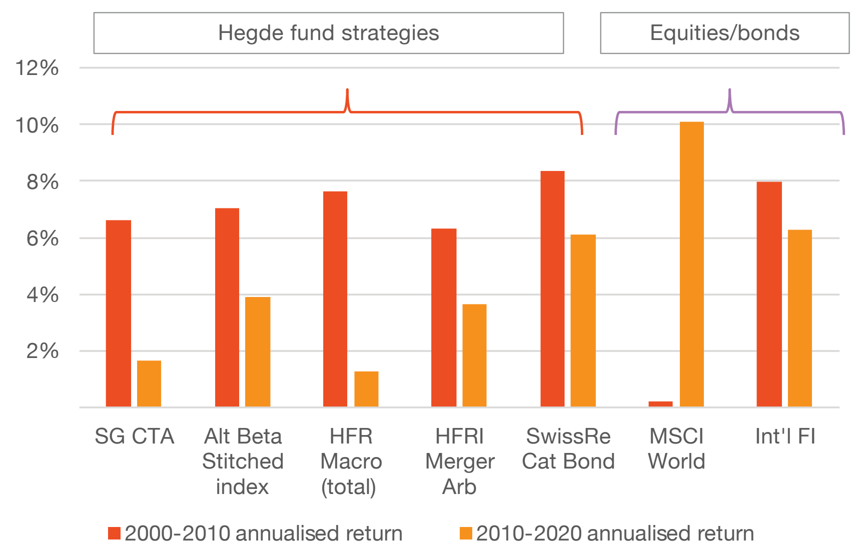
What has happened to liquid alternative investments?

After the global financial crisis, traditional markets like bonds and equities experienced steady growth with minimal interruption. This coincided with low equity-bond cross-correlation creating two strong asset classes which were mutually diversifying. As a result, there was no need for further diversification elsewhere.

Simultaneously, many hedge fund strategies were unable to repeat the risk-adjusted returns achieved in the previous decade – whether using trend-following or insurance-linked securities, the 2010's experienced notably lower absolute and risk-adjusted returns.

There have been multiple reasons suggested for the cause of weaker performance of various alternative strategies. These include the crowding of trades which erodes the potential alpha from any given trade, and central bank policy convergence resulting in minimal market divergences for hedge funds to exploit. Consequently, asset allocators now question whether there is still a place for alternative investments.

Chart 1: The tale of two decade



Source: Bloomberg. All returns displayed in USD.

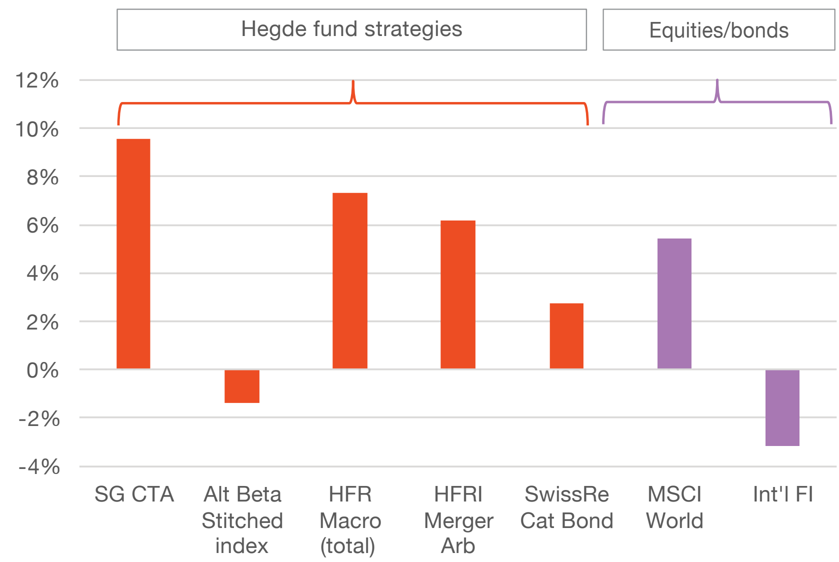
Hedge fund comeback

While the 2010s may have seen those with allocations to hedge funds questioning them, the last few years have once again illustrated their case and value. Bonds and equities don't always go up and they may well fall together.

This was seen in 2022, when inflation fears triggered interest rate hikes, leading to a decline in bond prices. This occurred alongside steep equity market drawdowns across the world, with interest rate rises coinciding with concerns surrounding valuations and an incoming possible recession. The diversification between the two asset classes broke down.

While many traditional asset classes have struggled since 2020, many hedge fund strategies have been highly successful, in particular trend-following and macro strategies which have been able to capture strongly trending and diverging markets across the globe.

Chart 2: Annualised returns since 2020



Source: Bloomberg. All returns displayed in USD.

A good diversifier, but is it well diversified?

A naïve takeaway from this analysis might be that investors would only find alternative investments attractive during periods of market stress that impact traditional investments.

Additionally, many of the hedge fund strategies mentioned are not highly diversified within their own right. For example, in the same way long-only equity funds are subject to equity market drawdowns, trend-following funds face risk when markets become choppy, and trends are minimal. Similarly, insurance-linked securities (ILS) funds are subject to the impact of significant natural catastrophes.

These concerns prompted Frontier to look for an asset class that addresses the following issues:

- The asset class should be a good investment in its own right, not just as a diversifier.
- The asset class should be highly diversified within itself.

A possible solution that addresses both of these issues is multi-strategy hedge funds.

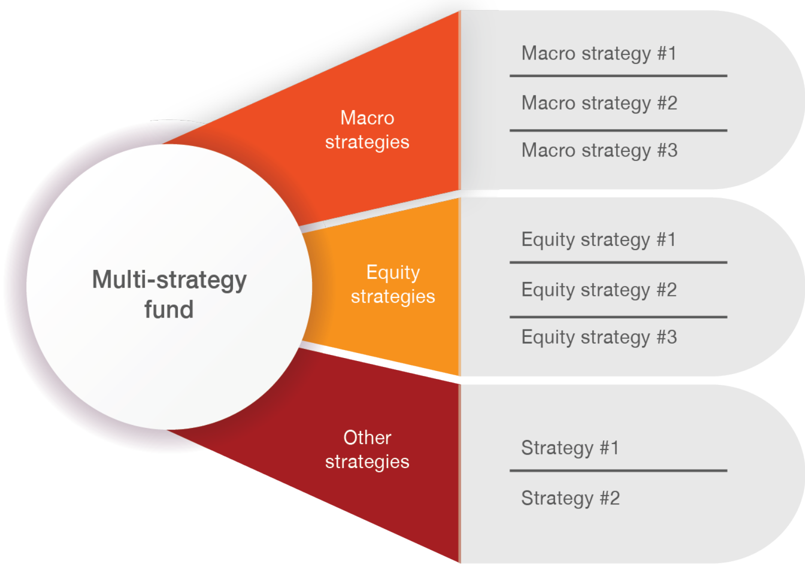
Introduction to multi-strategy funds

Multi-strategy funds may appear complex at first glance, but they are actually quite simple: they are funds which invest across a number of largely independent sub-strategies. These strategies can vary significantly from one manager to another, which we'll explore in more detail in the next section. By and large, these strategies go long and short financial instruments, so there is minimal broader market exposure, particularly at the fund level.

In effect, it is an internalised fund of fund, although external portfolio managers may be hired too.

Each multi-strategy will typically invest across five to ten of these strategy groups and have a number of specialist portfolio managers running specific strategies within each sub-strategy group. This can mean each fund may be running somewhere between 20 and 100 individual strategies.

Figure 1: Sample multi-strategy fund structure



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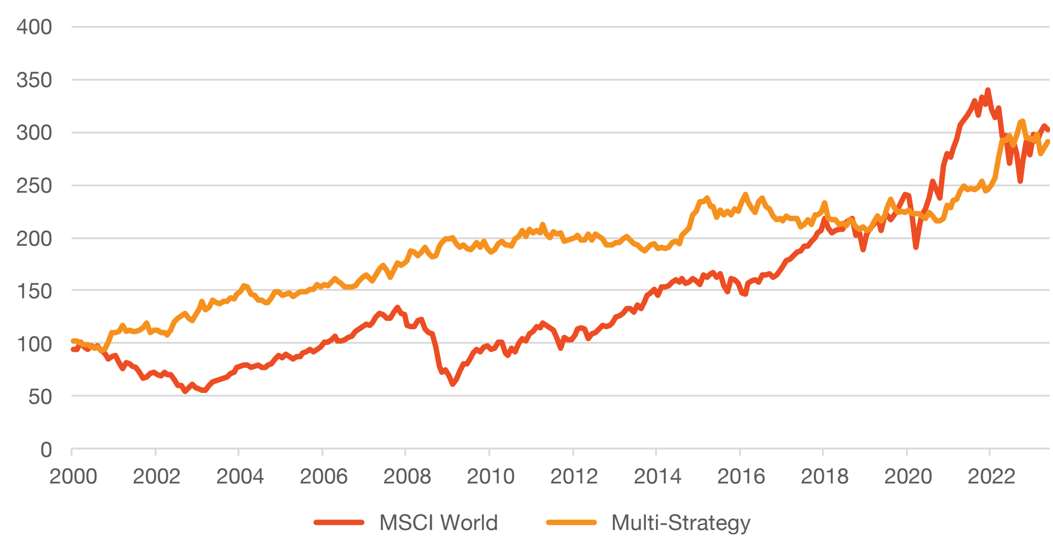
As a result of having so many individual minimally correlated sub-strategies, multi-strategy funds are able to benefit greatly from diversification.

Chart 3 shows the cumulative return series of the HFN Multi-Strategy Index, which tracks global multi-strategy funds compared to the MSCI World since 2000. During this period, the cumulative returns of the two series have been quite similar, although the path for the multi-strategy index has had a much steadier performance path.

Chart 3: Cumulative performance of multi-strategy versus global equities



Source: Bloomberg, eVestment. Multi-strategy represented by HFN Multi-Strategy Index. Returns in USD and net of fees.

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A summary of common strategies

As mentioned, multi-strategy funds often employ up to 20-100 individual strategies, which can be grouped into five to ten broader strategy groups. Table 1 shows a list of some of the most common strategies used by managers:

Table 1: Summary of common strategies

Strategy	Short description
Directional long/short equity	These are typically fundamental in nature however may be quantitative.
Equity market neutral (equally long and short)	These strategies are typically quantitatively implemented, however may be fundamental.
Fixed-income relative value	Long/short trading strategies that are independent of global fixed income markets, aiming to profit from convergence in security valuations.
Convertible arbitrage	These strategies exploit mispricing between convertible securities and the underlying securities.
Volatility arbitrage	Strategies that take long positions in 'cheap volatility' and short positions in 'expensive volatility'.
Capital structure arbitrage	Strategies that take long and short positions in securities within the capital structure of a single corporate.
Merger arbitrage	These strategies purchase equity securities for the acquiree of a recently announced acquisition.
Event driven	Strategies involved in both merger and non-merger events. Examples of non-merger event driven trades include trading in distressed securities, IPOs, and spin-offs.
Global macro	Tactical trading of global securities (equity indices, interest rates, commodities and currencies), using discretionary or systematic processes. May be relative value or directional.

More detail on common strategies

Long/short equity

Long/short strategies involve taking long positions in favourable equity securities, and taking short positions in unfavourable equity securities, aiming to exploit the relative outperformance of the long positions versus the short positions. The short positions may partially or fully hedge such strategies against broader equity market risk, so the resulting portfolio may be directionally long or market neutral.

Portfolio managers running long/short equity strategies tend to look to be geographical and/or sector specialists (e.g. US technology, European energy), aiming to profit from stock selection. Portfolio managers will typically combine top-down (macro) and bottom-up (micro) approaches, and are fundamentally driven, although a quantitative approach may also be used.

Equity market neutral

Equity market neutral strategies involve having simultaneous long and short positions in equity securities, aiming to profit from outperformance. Such strategies have minimal, if not zero, market exposure, either in terms of size (dollar-neutral) or beta (beta-neutral) at all points in time. They may also be country neutral, industry neutral, size neutral, or all of the above. As a result, they are strictly profiting off relative outperformance as opposed to the movements of broader markets.

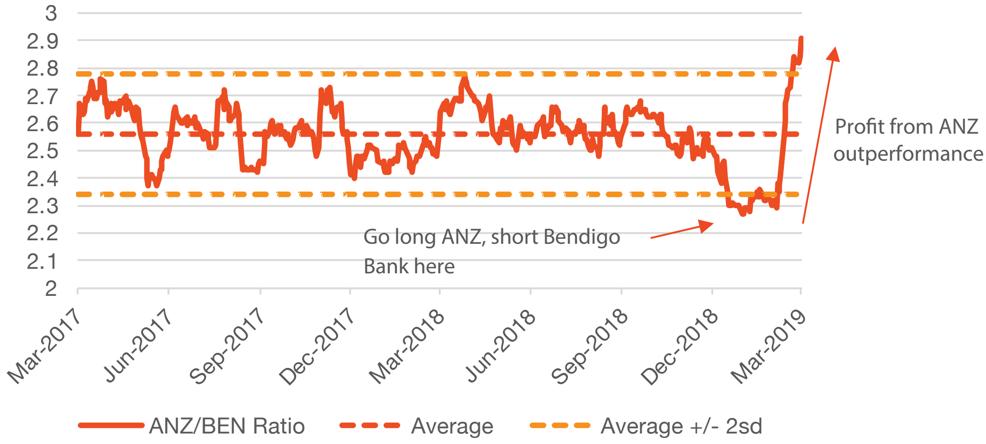
One type of equity market neutral strategy is a factor approach, where a long/short portfolio is constructed based on the forecasted returns of individual securities based on a number of factors. These factors may be based on fundamental information (e.g. valuations), technical information (e.g. momentum) or alternative data (e.g. using satellite imagery to forecast sales).

Equity market neutral strategies may include statistical arbitrage strategies such as pairs trading. This might involve looking at two ‘similar’ securities (based on some measure such as correlation or distance) for which there has been some large deviation in recent relative prices and taking a short (long) position in the overvalued (undervalued) security, aiming to profit from convergence.

Chart 4 illustrates a simplified example of pairs trading. ANZ and Bendigo Bank are two ‘similar’ securities whose share prices often move together. However, in late 2018, ANZ drastically underperformed Bendigo Bank. In this situation, a pairs trading strategy may purchase shares in ANZ and short sell shares in Bendigo Bank, profiting if ANZ subsequently outperforms Bendigo Bank.

Notably, the strategy can be net neutral by purchasing/short selling equal amounts in dollar or beta terms. In other words, the trade will profit as long as ANZ outperforms Bendigo Bank, regardless of whether the broader market is up or down.

Chart 4: Simplified pairs trading example - ANZ and Bendigo Bank



	ANZ	Bendigo Bank
Price on 01/01/2023	24.93	10.78
Price on 01/02/2023	28.03	9.62
Return	12.4%	-10.8%

Total return = Difference in returns = 23.2%

Source: Bloomberg, investment manager, Frontier Advisors.

Fixed income relative value

Fixed income relative value strategies typically involve the trading of liquid debt instruments such as government debt, corporate debt, interest rate swaps and asset-backed securities. The strategies involve attempting to capture the spread (i.e. the carry) between securities and/or mark-to-market returns from differences in relative performance.

A simple example of a fixed income relative value trade is the 'steepener' trade. This may involve going long the short end of the yield curve (e.g. by shorting a short-dated bond) and going short the long end of the yield curve (e.g. by going long a long-dated bond), aiming to profit from a steepening of the yield curve.

Other trades within this strategy might include government bond versus government bond (going long on one and short on another) and corporate versus corporate issuer.

Convertible arbitrage

A convertible security, like a convertible bond, is a mix of a regular bond with a call option on the underlying stock at a pre-determined exercise price. The simplest example of a convertible arbitrage strategy involves going long on the convertible bond, and short on the underlying equity to delta hedge the overall position. Portfolio managers will typically go long on convertible bonds that are the cheapest relative to some measure of theoretical fair value, using complex mathematical modelling or other methods.

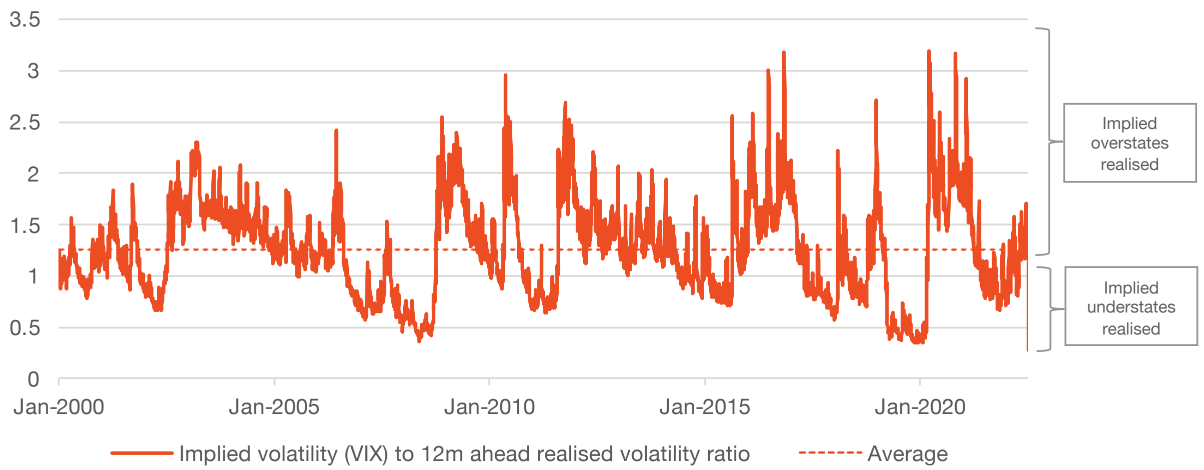
Returns from convertible arbitrage strategies can exceed the risk-free rate through exposure to the credit risk premia (although this can be hedged away in some instances by taking short positions in the issuer's credit); gamma trading the stock's volatility (i.e. changing the hedging ratio as delta changes, which generates returns due to the convertible's positive gamma); and exploiting pricing disparities between convertible bonds and their theoretical fair value.

Volatility arbitrage

In simple terms, a volatility arbitrage manager may take long positions in what they perceive to be 'cheap volatility' and short positions in what they perceive to be 'expensive volatility'. For example, they may purchase options where the implied volatility is lower than realised volatility is likely to be and sell options where the opposite is likely.

A simple example of volatility arbitrage involves going short volatility (e.g. by selling a put option and selling a call option). This is because historically, implied volatility from options prices tends to be higher than is realised over the following period. As a result, the arbitrageur will profit if the implied volatility of the option at the time of purchase is lower than is realised.

Chart 5: Implied volatility tends to overstate what is subsequently realised



Source: Citi, Frontier Advisors

Capital structure arbitrage

Capital structure arbitrage strategies involve taking long and short positions in different instruments within a single issuer's capital structure. An example might include purchasing a company's debt securities and short selling its equity securities (or vice versa). It may also involve assessing different tranches of a company's debt, for example short selling subordinate debt and purchasing senior debt from the one issuer.

As such, the capital structure arbitrage manager will realise profits and losses based on the relative performance of different instruments from the issuer.

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Merger arbitrage

Merger arbitrage involves taking positions in securities where the corporate is involved in a transaction, such as a takeover. Typically, this is purchasing the securities of the acquiree which is trading to a discount to the announced purchase price. It may also involve short selling the acquirer's shares in the case of a non-pure cash deal (e.g. if shares of the acquirer is being exchanged for shares of the acquiree).

The spread between the acquiree's current price and the announced price represent 'deal risk', as well as the risk-free rate. In simple terms, the merger arbitrage manager will be investing in deals where they perceive the deal risk to be lower than that which is implied by market prices. The process may be fundamentally driven, quantitatively driven, or a combination of the two.

Chart 6 illustrates a simple example of a merger arbitrage trade, using the acquisition of Sydney airport as an example. In this case, an offer to acquire shares in Sydney Airport (at $A) came in above the price before the announcement (at $C). Following the announcement, the share price was still trading below the announced acquisition price (at $B). In this case, a merger arbitrage manager may purchase these securities, and make the spread (i.e. $A - $B) in the case of deal closure.

Chart 6: Merger arbitrage example - Sydney Airport

Source: Bloomberg, Frontier Advisors

Event driven

Event driven strategies tend to centre around corporate events. A common type of event driven strategy is merger arbitrage, as listed above, although other event driven strategies may be present.

Another example of an event driven strategy is distressed securities, which are involved in taking positions in securities that either have been or are expected to be in financial trouble. A company may fall into distress due to liquidity issues, legal challenges, or otherwise, and the uncertainty around the situation often creates opportunities for distressed security investors.

Other examples may include partaking in IPOs, spin-offs or restructuring events.

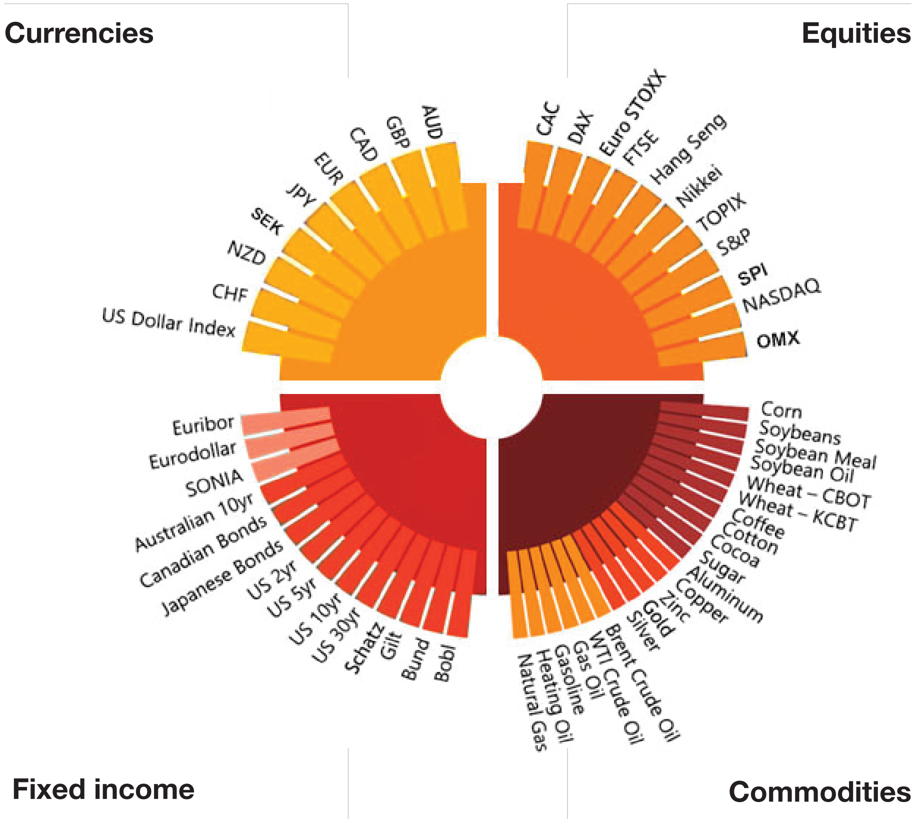
Global macro

Global macro strategies involve tactically trading global markets, such as equity indices, global rates, currencies, and commodities, based on the manager's anticipated price moves for these instruments. Trading is driven by a top-down approach combining fundamental (micro and macroeconomic data) and technical data (such as trends in recent prices), to analyse global conditions that may lead to differing performance across assets.

Global macro strategies may be systematic (e.g. using trend, carry, fair value, and fundamental data as inputs into forecasting returns) or discretionary (i.e. positions are up to the discretion of the portfolio manager, often using systematic signals to aid). Systematic strategies tend to have shorter term holds when compared to discretionary strategies.

Furthermore, strategies may be directional or relative value. Directional strategies have no constraint on net exposure (i.e. can be net long or net short in any given asset class), while relative value strategies are constrained to be neutral (i.e. equally long and short).

Figure 2: Example of markets traded in a global macro strategy



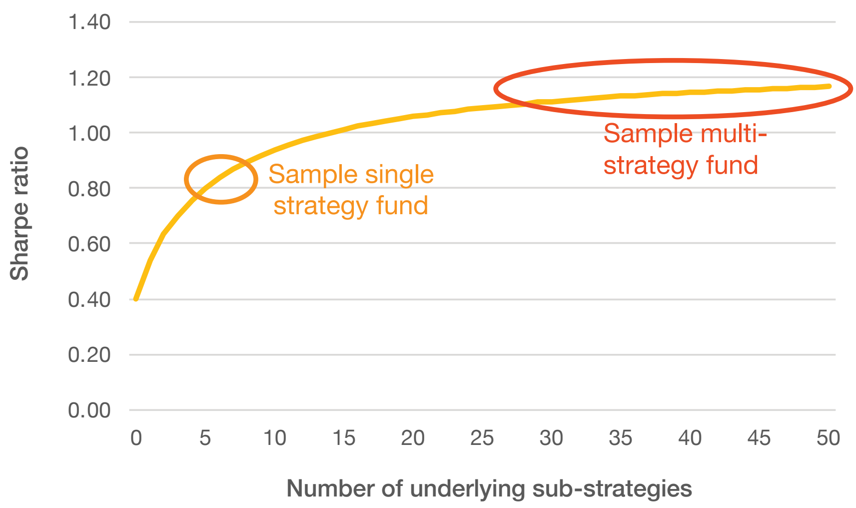
Source: Frontier Advisors

The reasons for multi-strategy funds

Diversification benefits from allocating to many uncorrelated sources of return

Consider a hypothetical example for illustrative purposes. There are approximately 50 strategies all yielding an expected return of 7% with a 10% risk. The cross-correlation between all of their returns is 0.1 (while positive, negligible) and the risk-free rate is 3%. Assuming all of these strategies are equally allocated to (e.g. 50% each for two strategies, 10% each for 10 strategies), Chart 7 shows how the Sharpe ratio at a fund level varies with the number of sub-strategies used.

Chart 7: Sharpe ratio versus number of underlying strategies



Source: Frontier Advisors

Diversification in multi-strategy funds can benefit investors in two ways:

- Being able to achieve the same level of return with a lower level of risk, i.e. by simply combining the underlying investments as described.
- Being able to achieve a higher level of return with the same level of risk, i.e. by combining the underlying investments but increasing the leverage of each to meet the same volatility.

Multi-strategy funds versus a diversified alternatives portfolio

The analysis so far shows the benefit of diversifying across different alternatives strategies with limited correlation. However, the question remains: why invest in a multi-strategy fund when you can build a diversified alternatives portfolio yourself?

Frontier has identified four key reasons why investing in a multi-strategy fund may be more favourable than investing in a diversified alternatives portfolio:

- **Best in class:** Despite being so highly diversified across different sub-strategies, multi-strategy funds are often best in class in a few or many of the individual strategy groups. For example, a multi-strategy's equity market neutral strategy might be one of the top equity market neutral funds globally on a standalone basis. In other words, the excess alpha may be gained through the outperformance of the individual strategies.
- **Dynamic allocation:** While not all multi-strategy funds employ dynamic allocation to individual strategies, those that do may be able to generate excess return through this process compared to a static allocation. For example, if outlook for convertible arbitrage strategies is strong, the multi-strategy might tactically dial up the allocation for this sleeve. In other words, the excess alpha may be gained through overweighting (underweighting) strategies in more (less) favourable environments.
- **Portfolio look-through:** The multi-strategy fund is able to examine the specific positions of different strategies, minimising the overlap between them at all times. In other words, the excess alpha may be achieved through maximising diversification.
- **Fee netting:** As a result of investing in a multi-strategy fund with minimal pass-through fees, an investor might be able to achieve a higher net return than an investor investing in a composite of single strategy funds because incentive fees are netted at a strategy level. In other words, the excess alpha may be achieved through paying lower fees, which we'll explore in the Fees section of this paper.

Implementation considerations

Diversifying an alternatives portfolio through single-strategy funds has several benefits too. The most obvious one is the degree of customisation available. For example, if an investor is looking explicitly for resilience against equity and bond markets, they may look toward allocating to a commodity trading advisor (CTA). Perhaps they're looking for something independent of financial markets, in which case an allocation to an insurance-linked securities (ILS) manager may be most appropriate.

While many multi-strategy managers have varying emphasis, they are unlikely to be able to tailor to each individual goal and the customisability will not be comparable with what can be achieved through various single strategy funds.

Furthermore, an asset owner will be able to shift allocations themselves depending on objectives and may pay lower aggregate fees for a diversified single strategy alternatives portfolio in comparison.

In the case of allocation to multi-strategy funds, Frontier recommends assessing the fund's individual strategies and how they fit into the overall portfolio.

Larger asset owners may also consider investing in a multi-strategy fund and having additional allocations to single strategy funds depending on their objectives. This is because multi-strategy funds can be considered diversified in their own right, although may not perfectly fit the objectives of the asset owner, and as such additional single strategy allocations may be warranted or necessary. On the other hand, smaller asset owners can consider a multi-strategy fund as an alternative to constructing a diversified alternatives portfolio through a number of single strategy options.

Table 2: Benefits of multi-strategy and diversified single-strategy portfolios

Multi-strategy	Diversified single-strategy alternatives portfolio
Potentially best in class implementation at the strategy level.	Ability to select the best manager within each strategy.
Dynamic allocation to various strategies done by the manager.	Ability to customise the portfolio to fit investment objectives.
Portfolio look-through at the security level.	Can shift allocations as desired or necessary.
Fee netting, depending on the manager.	Likely lower aggregate fees, depending on the manager.

Effects of inclusion into an institutional portfolio

Cash efficiency and the cash plus assumption

Unlike many other asset classes present in institutional portfolios, multi-strategy funds are able to directly benefit from increasing interest rates in an absolute sense given the nature of the implementation.

This is due to the cash efficiencies of the strategies which arise because of the long/short nature of many of them, as well as the instruments (e.g. derivative securities) used. For example, if the net exposure of a strategy is 0% – equally long and short, with proceeds from short sales being used to purchase longs – a portion of the portfolio will always be allocated to cash depending on margin requirements.

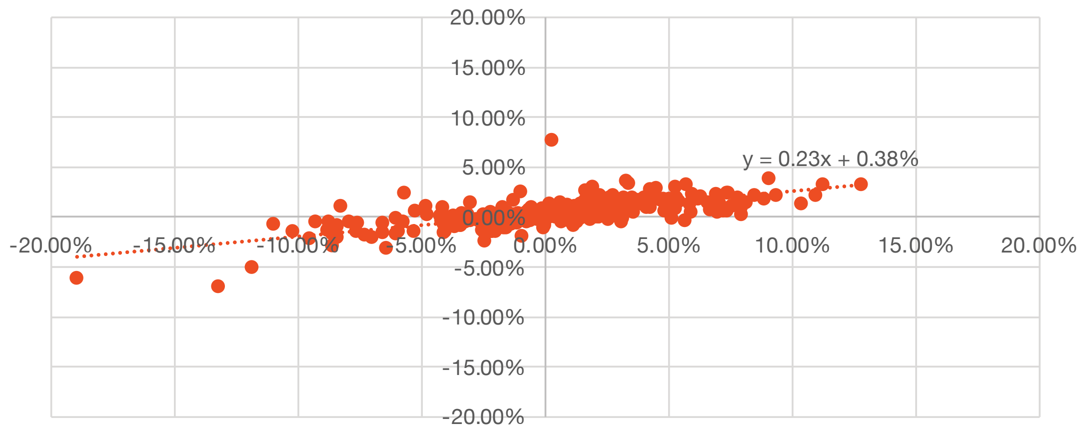
This means that, all else equal, the returns generated from a multi-strategy fund will be directly proportional to interest rates. This makes the funds more favourable in a world of higher cash rates.

Diversification and resilience

We have covered the benefits of investing in multi-strategy funds in isolation and will now look to the merits for inclusion in an institutional portfolio.

In particular, multi-strategy funds are diversifying when contrasted to global equities, as shown in Chart 8. This demonstrates multi-strategy funds are minimally impacted by broader equity market moves. The same can be said for global bond market moves.

Chart 8: HFN Multi-Strategy versus MSCI World, monthly returns



Source: Bloomberg, eVestment, Frontier Advisors. Data from January 2000. Returns in USD and net of fees.

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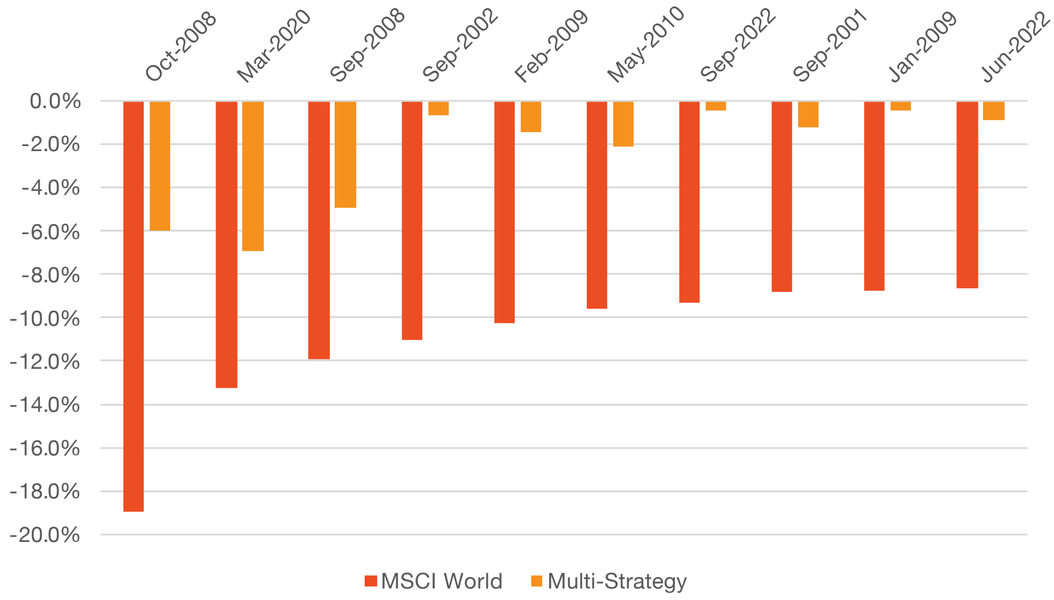
Chart 9 shows the performance of the HFN Multi-Strategy index in the ten worst months for global equities since 2000. It illustrates that, for the most part, multi-strategy funds are largely resilient to equity market shocks.

Chart 9: HFN Multi-Strategy in the ten worst months for global equities



Source: Bloomberg, eVestment, Frontier Advisors. Data from January 2000. Returns in USD and net of fees.

While some relationship is clearly present, a number of multi-strategy funds have strategies which are directionally long, such as equity long/short strategies with a long bias. There may also be strategies in the portfolio that, while largely uncorrelated, may be subject to poor performance in periods of heightened stress.

Even so, many options exist for investors seeking a multi-strategy with less broader market exposure and more resilience.

Portfolio construction with multi-strategy funds

To demonstrate the impact of adding multi-strategy funds to a diversified portfolio, we examine a hypothetical portfolio consisting of equities, fixed income, property and infrastructure and analyse the effects of incremental allocations to multi-strategy.

Rather than conducting a forward-looking assessment, the performance of the hypothetical portfolio is assessed historically for simplicity and to minimise the use of assumptions.

The base portfolio is a simplified institutional portfolio: it consists of 40% global equities (represented by MSCI World), 30% fixed income (represented by the Bloomberg Global Aggregate), 15% property (represented by FTSE EPRA Nareit Global Real Estate) and 15% infrastructure (represented by 15% S&P Global Infrastructure), rebalanced monthly without considering trading costs.

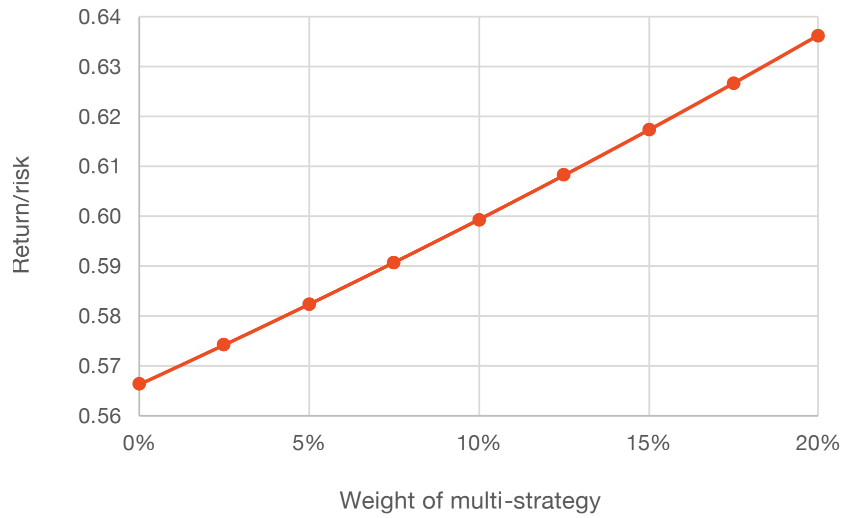
The comparison portfolios consist of incremental additions to multi-strategy funds (represented by HFN Multi-Strategy), and proportional decreases in allocations to equities, fixed income, property and infrastructure.

All returns are displayed in USD without consideration of currency hedging to generalise the analysis.

The first assessment made was the effect on risk-adjusted returns, one of the primary considerations for an institutional portfolio. Chart 10 illustrates two key points:

- There is a positive relationship between the weight of multi-strategy funds and the overall portfolio's risk-adjusted returns. In fact, each 5% increase in weight coincides with an increase of 0.015 to 0.02 (~3% in percentage terms) in risk-adjusted returns.
- This relationship does not diminish as the weight increases. In other words, the benefit of increasing the allocation remains present even for larger allocations.

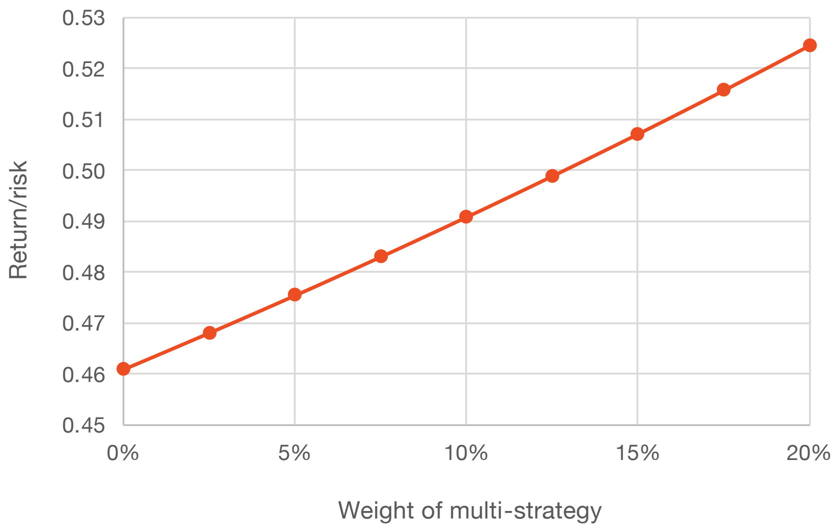
Chart 10: The effect of holding a multi-strategy allocation on risk-adjusted returns



Source: Bloomberg, eVestment, Frontier Advisors. Data from January 2002 to May 2023. Returns in USD and net of fees.

Interestingly, this relationship was still present in the most recent decade, which was a challenging period for hedge funds in general, as shown in Chart 11. This highlights the case for having a diversified alternatives allocation through various cycles.

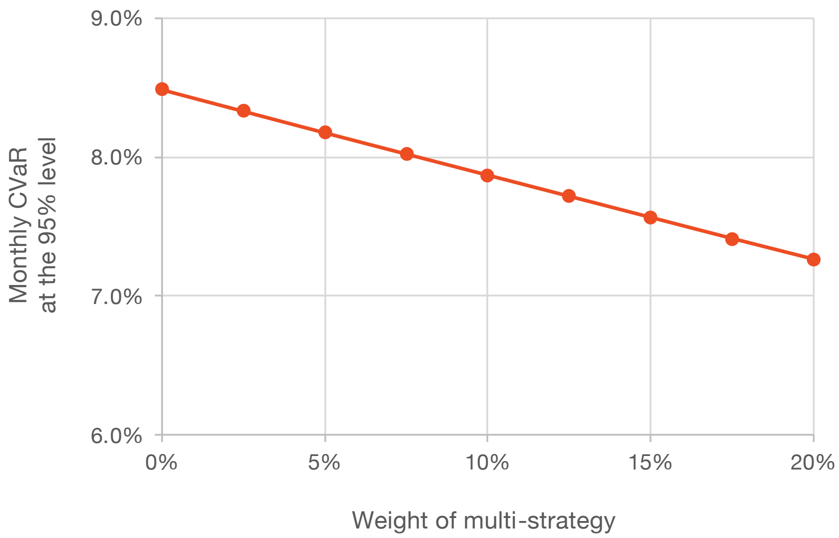
Chart 11: The effect of holding a multi-strategy allocation on risk-adjusted returns in the last decade



Source: Bloomberg, eVestment, Frontier Advisors. Data from May 2013 to May 2023. Returns in USD and net of fees.

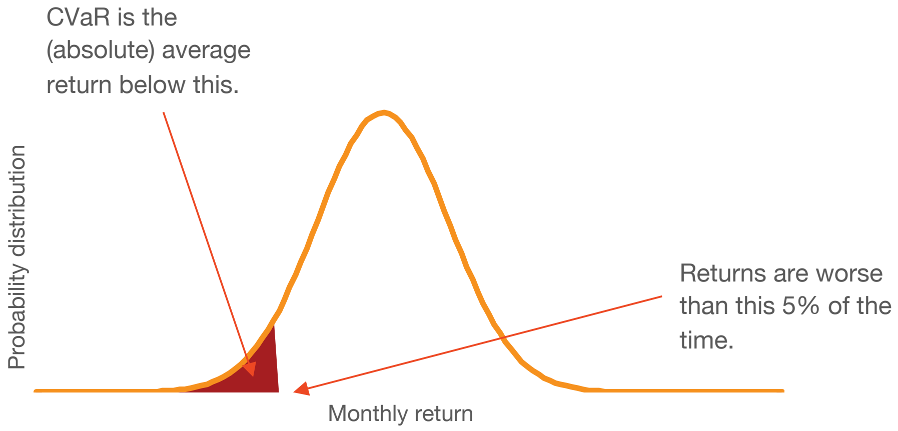
For investors concerned about downside protection, a similar relationship is present between the allocation to multi-strategies and drawdown protection. To assess this, the monthly CVaR at the 95% level (i.e. the average loss in the worst 5% of monthly returns) is compared across portfolios. Increasing multi-strategy allocations would have improved the capital preservation properties in the hypothetical portfolio. In other words, an allocation to multi-strategy is likely to reduce extreme tail losses at a portfolio level.

Chart 12: The effect of holding a multi-strategy allocation on conditional value at risk



Source: Bloomberg, eVestment, Frontier Advisors. Data from January 2002 to May 2023. Returns in USD and net of fees.

Figure 3: CVaR visualisation



Source: Frontier Advisors

The relationships shown between multi-strategy allocation, both risk-adjusted returns and downside risk, do not diminish for allocations above 20%. Although larger allocations may be considered, due to other considerations such as fees, liquidity, and complexity, it may be impractical.

Whether to fund with growth or defensive assets

For some investors, such as liability driven investors, how the allocation is funded needs to be carefully considered. In particular, whether alternatives are funded from growth assets (using equities as a proxy) or defensive assets (using bonds as a proxy) is important.

APRA-regulated insurers, bonds and defensive assets are typically more capital efficient than equities or alternatives, therefore using bonds as the funding mechanism for multi-asset strategies may result in a higher capital charge. In contrast, if insurers fund alternative strategies from equities, it is likely to lead to either little change or a lower capital charge so funding an alternatives portfolio from equities may be more appropriate. This trade is even more compelling if the alternatives portfolio targets an equities-like return for much lower volatility.

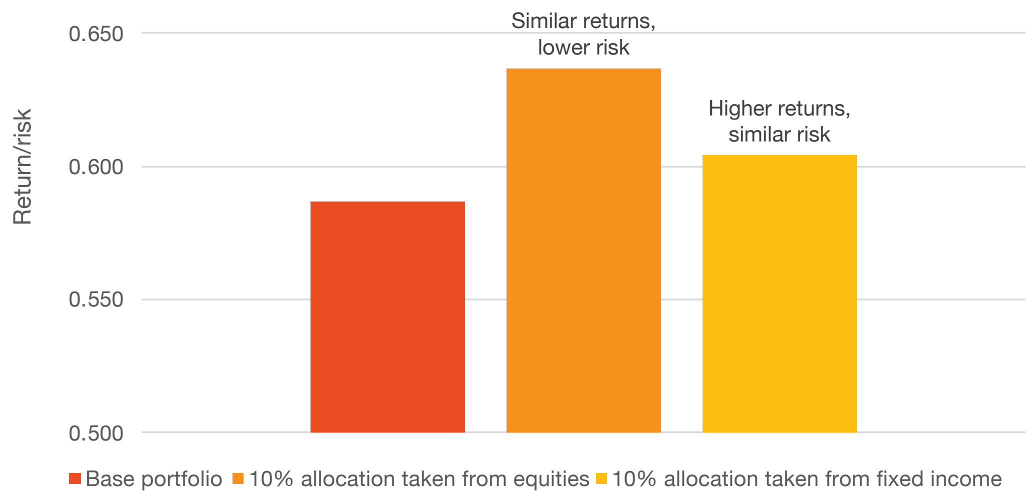
To model the impact of alternatives on an insurance portfolio, we make reference to a different type of insurer - a long-tail unregulated insurer. A typical portfolio consists of equities, bonds, property and infrastructure (using the same benchmarks as before). For the purposes of this analysis, weights of 40%, 40%, 10% and 10% respectively were applied to be better representative.

The two comparison portfolios are:

- Applying a 10% allocation to multi-strategy funds, taken from equities, and
- Applying a 10% allocation to multi-strategy funds, taken from bonds.

These are both assessed compared to the base portfolio on a risk-adjusted return basis.

Chart 13: Allocating away from equities versus bonds



Source: eVestment, Bloomberg, Frontier Advisors. Data from January 2002 to March 2023. Returns in USD and net of fees.

In both cases, expected risk-adjusted returns would increase, although more significantly when the allocation is taken purely from equities. For insurers this means when an allocation to a multi-strategy portfolio is funded from equities, it (historically speaking) results in better risk-adjusted returns (and likely a no greater capital charge for regulated insurers).

In the case of equities, this is coming from similar annualised returns with lower risk. In the case of fixed income, this is coming from higher annualised returns with a similar level of risk. So, while in both cases the risk-adjusted returns increased, an analysis should be conducted to determine whether this is predominantly coming from increases in returns or decreases in risk, or a combination of the two.

Fees

A word on fees

In a fee-free world, a multi-strategy fund would likely be a rational investor's first choice for a diversifier. However, in reality, in exchange for being responsible for so many strategies, multi-strategy funds often charge higher fees compared to their single strategy counterparts.

Base fees are around 1-2%, along with incentive fees of 15-20%. Beyond these, there may be a 'pass-through' fee, which is essentially an extra layer of fees to pay the individual portfolio managers, bonuses, and overall costs of running business. This type of fee may vary significantly from manager to manager and from year to year.

For the fee constrained investor, some managers effectively 'net' the returns on the individual investments so an investor only pays incentive fees on aggregated returns (on top of the existing base fee). As a result, these funds are effectively cheaper than the sum of their parts, although the percentage of the base fee and incentive fee may be slightly higher.

Table 3: Indicative fees for multi-strategy funds

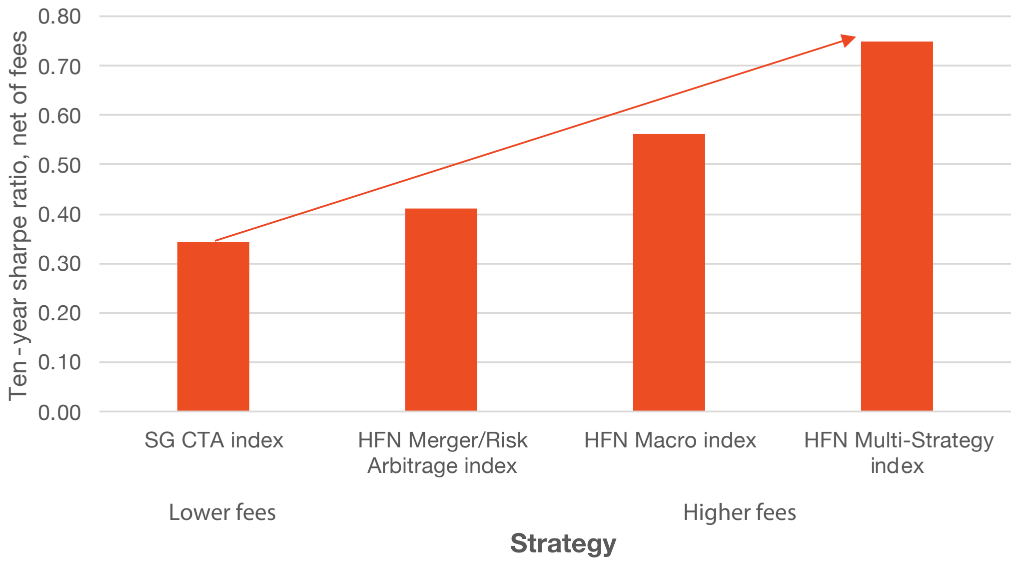
Fee type	Indicative range
Management	1-2% of assets
Incentive	15-20% on returns above hurdle, subject to a high watermark
Pass-through	Could be 0% for funds employing 'netting'; otherwise variable.

Relative to other alternative investments, are the fees worth it?

To assess whether the fees are justifiable in comparison to single strategy funds, Frontier has conducted a simple analysis of the trailing ten-year Sharpe ratio of a number of hedge fund indices.

Chart 14 shows the net of fees Sharpe ratio for multi-strategy funds is significantly higher than a number of single-strategy fund options like CTAs, macro funds, and merger arbitrage funds. This is consistent across different lookbacks and using different indices.

Chart 14: Fee analysis - Sharpe ratio by strategy



Source: eVestment. Data from May 2013 to May 2023. Returns in USD and net of fees.

While not necessarily conclusive, this observation suggests the benefits from investing in multi-strategy funds versus single strategies do not diminish due to higher gross fees, as the risk-adjusted returns remain higher even after accounting for fees.

Manager selection

The importance of manager selection

So far, there has not been reference to any individual manager. Given the complexity of the asset class and the number of strategies to which a manager may allocate, it is relatively heterogeneous as an asset class. Therefore, careful consideration is essential when selecting a manager for investment.

Some funds may be more so focussed on equity strategies, macro strategies or credit strategies. Some may have no clear emphasis. Furthermore, some may lean toward relative value strategies with minimal directionality and others may have a tilt toward directional strategies which bring in market exposure.

Table 4 shows sample statistics for a subset of the 25 multi-strategy funds Frontier has covered for which relevant data has been provided:

Table 4: Performance of multi-strategy funds covered by Frontier

Metric	25th percentile	50th percentile	75th percentile
One-year net returns	2.46%	4.64%	9.75%
Five-year net returns	4.54%	5.15%	7.30%
Ten-year net returns	5.24%	6.14%	7.39%
Ten-year net Sharpe ratio	0.69	0.93	1.58
Annualised risk, since inception	4.46%	5.89%	8.88%
Correlation to MSCI World	0.04	0.30	0.40

Source: Managers, eVestment, Frontier Advisors, data to March 2023. Returns are in manager's base currency.

The skew in risk-adjusted returns as well as the dispersion in correlation to equity markets highlights the importance of choosing the right manager.

When it comes to selecting an appropriate multi-strategy fund, Frontier emphasises several important dimensions to consider:

- The outlook for the individual strategies.
- The strength of the individual strategies' implementation.
- The individual strategies and their relationship with the broader portfolio.
- The extent to which the individual strategies are related to one another, and the number of them.
- Portfolio construction and risk management processes.
- Fees and liquidity.
- Business management and culture.
- Individual portfolio managers, analysts and non-investment staff.

These criteria vary greatly from manager to manager. To assist our clients with the challenges of manager selection, Frontier is continuing to conduct due diligence on the manager universe and may provide several managers views and ratings.

The final word

Frontier believes the case for multi-strategy funds can be made, both on a standalone basis and with respect to inclusion into a traditional portfolio due to the diversification benefits it presents.

Compared to single strategy funds, multi-strategy funds offer investors better diversification by investing across multiple alpha producing strategies. However, the degree of customisation is limited, and consideration should be on a case-by-case basis.

Investors can consider an allocation to multi-strategy funds as a one-stop solution for an alternatives portfolio, as the base for an alternatives portfolio with complementary single-strategy funds, or as a supplement to an already diversified alternatives portfolio.

Want to learn more?

Frontier has undertaken extensive research on multi-asset strategy funds and is well placed to advise investors on this. We encourage investors to reach out to Frontier's Alternatives Team for a discussion on how we may be able to help.

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